"And that man can have nothing but what he does (good or bad)"; And that his deeds will be seen (Al-Quran - An-Namj; LIII: 39, 40).

Global Financial Crisis (GFC) and Growth of Islamic Finance

The worldview of Islamic economics that emerged in the modern age in the 20th century AD after decolonisation of the Muslim world has witnessed practical manifestations particularly in the areas of banking and finance. Islamic banking and finance is now a part and parcel of the global finance being discussed and applied at national, multilateral and international levels. According to the Standard and Poor's report of 2009, assets of the top 500 Islamic banks expanded by 28.6 per cent, while many of the world's financial systems were deleveraging. As reported in the Global Islamic Finance Report, April 2012, Islamic finance developed during the past decade at an average rate of more than 30 percent per year against the traditional finance persistently caught up in one or the other crises. It is still tiny compared with the conventional finance, but it's a substantial number, all the more impressive given that Islamic financial institutions (IFIs) have only been back on the scene for three decades.

Until about 1570, most of the lending in the world was based on profit share, says Mohamed Ariff, professor of finance at Bond University. "After about 500 years, Islamic finance is undergoing something of a renaissance. Professors Kerrie Sadiq and Ann Black of the Queensland University of Technology wrote in a paper published in April this year, "Given such statistics,.. "it is suggested that Islamic finance…can contribute to global financial stability." It is projected by 2020, the Muslim world will be doing 50 per cent of its banking with Islamic institutions." [1]

The growth has been broad-based to encompass all major areas and sectors including commercial and investment banking, *Takaful*, corporate and public sector financing, fund management, money and capital markets, micro, SME and trust financing and last, but not the least,

[1] Mike Seccombe (2012); Jesus Saves, Moses Lends, Muhammad Invests; (July 9); http://www.theglobalmail.org/feature/jesus-saves-moses-lends-muhammad-invests/297/

hedging techniques, credit risk securitization and other financial derivatives.

GFC: Causes and Impacts:

The GFC originating from reckless lending, excessive leveraging and innovative complex financial products, affected virtually every aspect of the global economy and ultimately the masses. In addition to the general impacts in the shape of inflationary spiral and reduced real income and employment opportunities, the GFC led to the Euro crisis 2011 in general and the Greek Debt crisis 2012 in particular. The Governor, State Bank of Pakistan, observed in his recent address to the 9th IFSB Summit, "The instruments that were meant to disperse financial risks instead allowed financial institutions in general and the banking system in particular to become highly leveraged that ultimately lead to financial meltdown. As a result, it not only put the innovations in the financial markets under the spotlight, but also singled-out regulatory and supervisory weaknesses in assessing the risks associated with financial institutions, markets and innovative financial products"[2].

It is commonly known that the chaos generated from the widespread securitization of the sub-prime mortgages by banks in America – parcelling mortgages into small amounts, packaging them in large components and selling them as new securities. As a result, the high-risk mortgage debts and the sub-prime mortgage based securities (MBS) appeared in the portfolios of the major financial institutions in the world. Debt securitization became a fashion for generating more liquidity and profits while shifting credit risk to others. Default by the mortgage holders affected all such institutions and ultimately the global finance and economy. Banks then became extremely conservative about further lending which lead to credit crunch affecting aggregate demand leading to falling output, unemployment and recession. Islamic finance practitioners have to learn many lessons from the persistent crises. Several factors have been indicated as causes of the GFC:

a) Many believe that instability is inherent in the conventional financial system – Minskey's Financial Instability Hypothesis, 1991[3]. It happens due to cumulative effect of hedging, speculation and Ponzi finance that creates need to attract ever greater sums of money;

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[2] http://www.bis.org/review/r120615l.pdf
http://www.sbp.org.pk/about/speech/Governors/Mr.Yaseen.Anwar/2012/16-May-2012.pdf

[3] In Feldstein M, (Ed), The Rik of Economic Crisis; University of Chicago Press; Pp 158-166.

b) Banks' engagement in riskier investment banking practices after abolition of the 'Glass-Steagall Act' in 1999 – increasing risk exposures and bypassing the regulations one way or the other;

c) Loose monetary and macroeconomic policies coupled with financial engineering for financial expropriation / systematic extraction of financial profits[4];

d) Ethical abuse inherent in the interest based system – moral and spiritual hypothesis; The massive bail-out packages accentuated the reckless behaviour and moral hazard problems and imposed huge cost on the tax payers to protect private gains of the hedge fund managers;

e) Inadequate market discipline vis-a-vis increasing greed, speculation for higher profits and too big to fail syndrome; and

f) Globalization impact – any crisis affecting a major economy or a group of countries would affect the world economy and finance

The Post-Crisis Finance

The causes and the failing policy response adopted so far to resolve the issues tend to reveal that the present state of the global financial system requires a complete overhaul of the structure and functioning of the financial system, institutions and instruments / products[5]. However, as the regulators and the policy makers at the states' level are not taking such bold steps, the financial institutions are operating almost on the same line and length. A burgeoning debt is the severest problem not only of the governments and the general public of the poor and developing economies, but also of the rich and advanced economies. "Since 2007 (the year the financial crisis began) government debt in the advanced economies has increased on average from about 75 per cent of GDP to more than 110 per cent ..... Government deficits had more than quadrupled on average over the period." ... .. Big banks continue to have an interest in driving up their leverage without enough regard for the consequences of failure". A BIS report diagnosed the problem in the words: "Unsustainable debts were ultimately the source of the financial crisis, and there is little evidence that the situation has become much better since." (Mike Seccombe, 2012)

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[4] Lapavitsas, C (2009) and Truman, E. M (2009), cf: Mobolaji, H.I; (2012); Global Financial Crisis and Ethical Concerns in Financial System; JIB & F, Karachi; Vol.29, No. 2, April-June, 2012

[5] For the urgency of need for new paradigm and complete overhaul, please see the report on Keynote Address by Prof. Khurshid Ahmad and Dato' Seri Anwar Ibrahim to the ICIB 2012, included in the present Issue of the *JIBM*.

The System Having Potential for Sustainable Development

Minute analysis of the above events and the causes would reveal that colossal harm to the global economy occurred due to institutions, markets, procedures and the instruments working against the rationale and really ethical principles of Islamic finance, which, *inter alia*, include:

i) Complete ban on *Riba* / interest (return without taking business risk or making any value addition);

ii) Avoidance from *Gharar* (lacking information certainty, ownership or ineffective control of the parties over the counter values);

iii) Exchange of real assets or papers representing the real assets – not notional / virtual / fictitious assets;

iv) One cannot sell what he / she does not own;

v) Prohibition of sale of debts except at face value with recourse, and

vi) The owner of an asset has both risk and reward of that asset –risk must not be separated from real economic activities.

Sadiq and Black (2012) summarise the features of Islamic finance as "the ban on interest, the ban on speculation, the ban on financing certain economic sectors, the profit- and loss- sharing principle and the asset-backing principle"[6]. Islamic finance does not approve the complex deals in the financial markets — "the layers upon layers of debt and interest, side bets and speculation built on tenuous tangible assets, which are completely detached from reality". Professor Michael Skully, of the faculty of Business & Economics at Monash University, agrees saying, "The things that killed us were the financials. When we talk about the Islamic funds doing better, it was a function of them not being exposed to financials and highly levered companies".

Islamic finance is more about facilitating the real sector including commodity producing, commerce and business sectors. Professor Constant Mews of the Monash University confesses with regard to Islamic finance: "The interesting thing about Islam is that it was a much more commercial culture from the outset than Christianity." It was by dint of this culture that from around the middle of the eighth century to the middle of the 13th, the Islamic world enjoyed a golden age, while European Christians were struggling through the Dark Ages (c.f: Mike Seccombe, 2012).

Opportunity for Islamic Finance

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[6] Kerrie Sadiq and Ann Black, Embracing Sharia-Compliant Products through Regulatory Amendment to Achieve Parity of Treatment; Sydney Law Review [VOL 34:189 2012] see the link: http://sydney.edu.au/law/slr/slr_34/slr34_1/SLRv34no1SadiqandBlack.pdf

The chaotic global market conditions both in developed and developing economies provide an opportunity to Islamic finance scholars and practitioners to come with real and long term solution to the current problems as envisaged in the original theory of Islamic economics, banking and finance.

A basic requirement is that the policy makers and regulators encourage financial practices which are not usurious, not speculative, and are based on real assets and real ethics. Hence, Islamic finance scholars and experts have to persuade the policy makers to cater to linking the finance with the real business and to turn to risk / profit sharing; and it is possible only when they confine themselves to financing the real business and adopt risk-sharing as their main investment tool.

Is Islamic Finance prepared to avail of the Opportunity?

Practices and performance of the IFIs, however, are much divergent from its principles. They have started using complex derivatives, the short-selling and all other ways the modern financial engineers have invented to make excessive amounts of money from money, without reference to real sector economy or to valid assets. The world – both Muslims and non-Muslils must understand as to why *Riba* - interest / usury is so hated by all revealed religions. Besides, almost 4,000 years ago, the Code of *Hammurabi* expressed concerns about the ethics of finance and the exploitation of lending. Ancient Vedic texts of India also condemned usury. In fact, it was a common concern among most religions. Islamic finance practitioners and financial engineers, apparently accept the above stance, but have been using objectionable structured and *'opaque'* investment tools since the dawn of 21st century, particularly since 2007, while the metals, stocks, or other commodities and currencies are used only as a vehicle for speculation without observing the relevant principles of Islamic law of contracts. Netting-out is an integral part of the most of these structures, using *W´ad* (as alternative to contract) and / or organized *Tawarruq*. While doing so, they are providing support to the conventional financial institutions that, as agents for buying and selling, do not bother for quality, quantity of the goods or fulfilling the S*harī´ah* essentials of trading. The early they understand, the better that Islamic finance can deliver and prosper on sustainable basis only if it follows its fundamental principles in true spirit. Injecting absolute uncertainty in a contract at the inception invokes prohibition; neglecting that prohibition would lead to convergence with conventional finance – only a bad name and loss of integrity without any benefit to global economy and the mankind.

Keeping in view all above factors, the plans, policies, tools and instruments and their procedures, the governing rules and ultimately the potential of Islamic banking and finance have to be revamped and carefully re-evaluated in line with the Shariah principles so that strategic plans could be made at micro and macro levels reflecting the real objectives of enhancing socio-economic harmony, stable growth and development and success for the mankind in broader perspective. It is in coincidence with a clarion call for ethical finance and an alternative financial framework coming through a part of the incoming literature and many conferences and forums. World Economic Forum (WEF) in Devos with the theme, "Shaping the Post-crises World" held in 2009; World Social Forum (WSF) in Benmem, Brasil, "Another World is Possible" and a number of other forums ended up in search for a credible alternative. Similarly, a number of Western leaders, economists and financial experts are willing to allow Islamic financial institutions to play a more active role as a possible way of coming out of the current ailments that are direct result of the exploitative and speculative free-market forces.

New Policy Options – Need for bridging the Gaps

Islamic finance is the alternative that, if applied, can help in resolving the impending issues. It would need bridging many gaps and joining many missing links that may include:

a) Creating a close link between financial flows and productivity because Islamic finance is driven by production and trade; finance must not be made tool for illegitimate gains through interest, gambling and unethical practices;

b) The GFC must inspire the IFIs to follow a different paradigm. Their activities must be insulated from potential risks resulting from excessive leverage and speculative financial activities. The relative stability of the IFIs even during the GFC was because they were not exposed by that time to derivatives. But they have been increasingly compromising on the fundamental principles and strong ethical values for mere profit motives.

c) Consequent upon the above, all financial assets must be contingent claims and there should be no sale of debts, debt instruments with fixed or floating interest rates[7].

d) As suggested by Knight (*Uncertainty and Profit*; 1921, Reprint: 2002), risk can be reduced "by slowing up the march of progress". Hence the

[7] Mirakhor and Iqbal Zaidi; Stabilization and Economic Growth in an Open Islamic Economy; IMF Working Paper Vol. 22; 1988; Pp. 1-37.

IFIs should not be marching on the footsteps of the conventional institutions to earn profits; they will have to avoid from all games of chance and financial derivates including futures, options and swaps that could be tools of extraordinary benefits to innovators of complicated synthetic products, but harmful for masses and the global economy and finance.

e) Forward sales, selling that one does not own and possess, and hence creating financial assets on the basis of future potential of growth in goods and services is valid in Islamic finance only when it is subjected to the conditions imposed for the valid Salam rules well defined in the theory of Islamic finance.

f) The scheme of actions as suggested above would require well thought out policy measures to control money and credit in national economies and global finance. Inflation targeting, monetary policy and its management have to be geared to ensure that financial flows are just sufficient to facilitate the growth of the real sector. No doubt, it is highly difficult and challenging task particularly due to high levels of debt stocks and the exogenous factors in the global economy. But there has to be any way-out and, to start with, that is responsibilities of IDB and IDB member countries in collaboration with multilateral institutions and forums like IMF, World Bank, BIS, WEF, IFSB, etc. Top level authorities and the policy makers at the world level be made to understand that stable future for human beings and the global economy is possible only by following the rational, ethical and divine rules that are for all and not for the Muslims only. The international regulatory bodies including Financial Stability Board (FSB), IMF, BIS, Basel Committee on Banking Supervision (BCBS) and national supervisory bodies have suggested reforms for improving the soundness of the banking system, addressing the Systemically Important Financial Institutions (SIFIs), developing macro-prudential policy tools, and strengthening the accounting standards, disclosure requirements and crisis resolution framework. The BCBS recommendations referred to as Basel III are aimed at raising the level and quality of capital, introduction of leverage ratio, capital conservation buffer, counter cyclical capital buffer and liquidity coverage and net stable funding ratios. But, all these measures have to be associated with solid principles for any sustainable and effective solution.

g) Any reference rate and Islamic Inter-bank Benchmark(s) (IIBR) have to be developed for pricing the Islamic banking contracts. These

benchmarks must be based on the real sector business and activities. It would be a great contribution of the economists and practitioners if they introduce such benchmarks for various sectors and sub-sectors that is possible only through surveys and research of various sectors. (The IIBR introduced by a group of IFIs about 6 months ago with involvement of *Thomson Reuters systems* has nothing to do with the real business activity of the member banks or the relevant markets. It is a money market rate just like LIBOR, EIBOR or any other conventional rate that the investor banks offer to one another[8]. A number of Islamic banks may be quoting rates for inter-bank liquidity placements for overnight, one week, one month to a year terms. However, it is not permissible to price a money placement transaction due to being *Riba*.)

h) Investments have to be determined by real savings and savings to income ratio and not by credit multiplier so that the growth of financial activities is stable and determined by the real growth in an economy and not by unstable speculative finance or money creation by the banking system.

i) Securitization not backed by the real assets that is based on excessive leverages and speculation has to be avoided.

j) *Sharī΄ah* advisers and scholars have to be very careful in allowing structured and derivative products even for the purpose of 'genuine hedging' because it could open a dangerous door of speculation which the *Sharī΄ah* experts might not intend to allow. The experience has shown that limiting the practitioners to the permitted and *Sharī΄ah* conforming purpose is next to impossible. Attention must be given to the aspects of *Sharī΄ah* compliance and *Maqāsid-al-Sharī΄ah* while performing risk management and hedging.

k) The concept of 'Ethical finance' is being increasingly accepted in the global finance. But, the scope of business ethics has to be broadened to include, inter alia, focus on righteousness, disclosure and transparency, mutual trust and integrity; and prohibition of risk-free and speculative finance – the ultimate cause of all financial ills. These are the virtues that are *sin qua non* for any sustainable business. An act or an instrument / product would be ethical when it is intended to produce

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[8] For details, please see the links:
http://thomsonreuters.com/news_ideas/press_releases/?itemId=518321;
http://thomsonreuters.com/products_services/financial/islamic_interbank_benchmark_rate/

the greatest net benefit to society when compared to other alternatives[9].

l) Islamic finance does not mean earning profit *per se*; as a part of Islamic economics, it refers to a well-defined system of rights and liabilities of all individuals and institutions in a society. It strives for preservation of property rights, sharing of risk and reward according to set rules and promoting social and distributive justice with special reference to equality of humanity, justice and equity, equitable distribution of wealth and *Falah* of human society as a whole.

m) While selecting personnel for banking business, Islamic banks and financial institutions have traditionally been focussing on past experience of the applicants. Trend has to be changed now as large number of personnel with proper education in Islamic finance are available who have been graduating from various universities and high quality training institutes. In this respect, the quality assurance institutions and the regulatory bodies must register the education and training institutions to ensure that the education, orientation and the training imparted is of the highest possible standard to produce professionals with necessary knowledge and the commitment. While designing the courses and the curriculum, the modules on Islamic business and finance ethics may also be added. IFIs should have the arrangement for continuous orientation programs for practitioners at all levels to uphold the ethical values as against the mere profit motive.

n) Special arrangements are needed for education and orientation of the *Sharī´ah* advisors and members of the *Sharī´ah* supervisory committees of IFIs. For this, focus is needed on interpretation and application of AAOIFI standards, documentation and process flow of the products and financial innovations in the global finance along with the procedures involved.

o) Only the stringent regulatory rules and strengthening the corporate governance as done after failure of institutions like Enron and WorldCom would not serve the desired purpose; this is why, even the Vatican suggested to the financial institutions a few years back to look at the rules of Islamic finance. Efforts have to be made across the globe to introduce the ethical principles. Mere enforcement of rules, irrespective of the ethics, is not only ineffective, but also costly. Sarbanes-Oxley Act was introduced in America in 2002, but it failed

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[9] Schwartz and Carroll, (2003) Corporate Social Responsibility: A Three-Domain Approach; Business Ethics Quarterly, 13(4), 503-30.

to avoid failures despite spending hundreds of millions of Dollars on its enforcement. First step has to be to make the ethical principles inherent in the business of the IFIs. To start with, AAOIFI's *Sharī'ah*, accounting, auditing and governance standards have to be made mandatory for them. It has also to be the first step of all regulations to be introduced by the central banks, Securities and Exchange Commissions or the other regulators both for efficiency and ethics. An attempt to apply Islamic ethical norms of freedom from *Riba*, *Gharar*, *Ghaban*, *Najash*, *Jahalah*, *Ihtikar*, etc would in general lead to enhancement of efficiency[10].

p) Accounting standards to be used by the IFIs also need to be redefined to suit the special nature of business to be conducted by institutions working on the basis of *Sharī'ah* based contracts. It would need special adaptation of the International Accounting Standards (IAS) and the Financial Accounting Standards (FAS).

q) A high level of disclosure and transparency is the basic feature of all transactions to be conducted by IFIs. Disclosure requirements with regard to investment portfolios, exposures in securitization, asset-backed / based papers and mortgage-backed securities, profits and on and-off balance sheet items also need to be revisited to make the investments by the IFIs transparent, *Sharī'ah* compliant and feasible. Mandatory disclosure requirements reduce asymmetry of information and tend to ensure just treatment with the parties.

The above is the long list of doables – a big challenge for all stakeholders of financial system. But this challenge has to be met to achieve the objective of safe and sustainable future for the mankind. It is what the Quranic verses, *"And that man can have nothing but what he does; and that his deeds will be seen"* and *"As for those who strive hard in Us, We will surely guide them to Our Path* (XXIX: 69), convey the message. It is the law of the nature as also the ruling of Almighty that He guides those, to the right paths who strive hard in the right direction as advised by Him.

Allah Almighty may guide us to the right path – *Aameen*.

MUHAMMAD AYUB

10 Obaidullah, M. (1995); Ethics and Efficiency in Islamic Stock Markets; International Journal of Islamic Financial Services, 3(2)